Response of Dominion Virginia Power to the "Generalized Framework"
Presentation by Howard Spinner on April 7, 2003

On April 10, 2003, the Commission Staff summarized as "Proposal 2" the proposal that Howard Spinner presented to the work group on April 7, 2003. With all respect to the Staff, Dominion Virginia Power does not believe the summary adequately captures the complexity of Mr. Spinner's methodology. The unknown factors and speculation that would be involved in the 30 plus year projection required by his proposal are mind-boggling. Mr. Spinner understands this. In addressing the effort to project market prices for one year in the pilot programs, he testified: "While it is relatively straight forward to determine the capped generation rates…the determination of market prices for generation is much more difficult. In fact, it is difficult to determine the market value of a given quantity of electric power during an historical period, much less the future." *In the matter of considering an electricity retail access pilot program*, Case No. PUE-1998-00814, Prefiled Testimony of Howard M. Spinner, 28-29.

What Mr. Spinner presented to the work group was a conceptual "general framework" for monitoring stranded costs "consistent with the Act." Specifically, Mr. Spinner referred to § 56-595.C.(iii) as the authority for his proposal. He admitted, however, that his proposed methodology was conceived without regard to the legislative background of the Restructuring Act.

As Dominion Virginia Power understands Mr. Spinner's proposal, his methodology requires complex calculations and thousands of data inputs and assumptions. First, market prices would be projected for the remaining economic lives of a utility's generating assets, which would be more than 30 years in some cases. During the time period prior to July 1, 2007, the difference between capped rates and these projected market prices would be considered stranded costs, or stranded benefits, depending on whether such market prices were below, or above, capped rates.

After that date, the relevant difference would be the amount between projected market prices and a utility's projected *generating costs*, rather than capped rates, since capped rates would no longer be in effect. Again, at any point in time, these generating costs might be above projected market prices, producing stranded costs, or below market, yielding stranded benefits. Second, the present value of a utility's projected stranded costs would be compared to the present value of any projected stranded benefits during the study period to yield a net stranded cost or benefit amount. Third, the difference between a utility's capped rates[1] and what its estimated annual cost of service would have been had the Restructuring Act not been adopted would be estimated to ascertain "recovered" stranded costs. This assumes, of course, that such estimated cost of service was determined to be below, not above, capped rates. Finally, the amount of "recovered" stranded costs would be compared to the "net stranded cost/benefit" amount to determine whether stranded costs are projected to be over- or under-recovered during the capped rate period.

Mr. Spinner's proposed methodology would require the determination of thousands of important data inputs and assumptions regarding the following:

1. the study time horizon, remaining economic lives, and contract terms for current generating resources;

2. the following statistics on each utility's generating resources:
   - remaining economic lives for a regulated and market environment
   - capacity factors derived from dispatch requirements under regulated and market scenarios;

[1] Although Mr. Spinner did not discuss in detail the role of wires charges in his methodology, Dominion Virginia Power assumes he would agree that wires charges would supplant the above-market portion of capped rates for those customers who "shop" during the capped rate period. Under his methodology, wires charges are thus simply a means to ensure that utilities are financially indifferent as to whether customers switch to a CSP or continue to pay capped rates.

3. an estimate of market prices over the period of a utility's current generating facilities' lives and power purchased contract terms or the study time horizon, if different;

4. an estimate of the retail rate for default service after July 1, 2007, (if less than market price in (3));

5. a discount rate for the required present value calculations;

6. what each utility's estimated annual cost of service and fair rate of return would have been from 1999 until July 1, 2007, assuming the Restructuring Act had not been adopted; and

7. after July 1, 2007, a utility's estimated capital and operating costs of each of its generating assets for their remaining economic lives.

In summary, such projection and assumptions would supposedly show an amount equal to the present value of a utility's above-market (stranded) costs, compared to the present value of any stranded benefits, less any amounts recovered under capped rates above a utility's assumed cost of service from 1999 until July 1, 2007. The latter calculation (amounts recovered under capped rates above a utility's assumed cost of service) are referred to by Mr. Spinner as the "Virginia twist," i.e., a different analysis than those found in stranded cost methodologies used or proposed in other jurisdictions.

Mr. Spinner was candid about his proposed study. He admitted his methodology would be "fraught with controversy every step of the way" and "very, very difficult." The difficulties, of course, are well known. The Commission has observed that "long-term market prices of a sensitive, non-storable, essential product with highly volatile, weather-sensitive demand cannot be estimated within the bounds of reasonable accuracy." Appendix A, p. 1.[2] The Commission has also noted that in some cases, projections would have to extend decades into the future because some "existing utility assets may have a remaining useful life of over 30 years." *Id.*

[2] "Appendix A" is attached to Dominion Virginia Power's response to the Commission's Order Establishing Proceeding dated March 3, 2003.

"Factors such as potential life extensions of assets and new environmental upgrades would further complicate the calculations," according to the Commission. *Id.*

Another complicating factor would be an incumbent utility's potential role in providing default service. For example, there is the question of whether Dominion Virginia Power's generation will be required to "back up" other default suppliers and, thus, will be dedicated to Virginia. If the answer is yes, this factor will have a significant impact on any stranded cost projections using the Spinner methodology; callable, non-firm projected market prices will be much different than non-recallable, firm power prices.

Other Commission statements further illustrate why Mr. Spinner's method would, as he said, be "very, very difficult." In comments made to the SJR 91 subcommittee on May 26, 1998, Richard Williams, Director of Economics and Finance at the Commission, stated that "I don't think I have to tell you the number of assumptions that would have to be involved in each of those calculations . . .. A change in the projected market price of 15% up or down could either eliminate or double the stranded cost calculation." Attachment, p. 1.[3] He also said that "I hope you don't mind my making a brief editorial comment, but policy implementation which locks in stranded cost recovery based on long-range forecasts and market prices under a market structure that does not currently exist could prove disastrous." *Id.*

During the debate prior to adoption of the Restructuring Act, the Commission implicitly rejected Mr. Spinner's type of methodology by stressing the importance of flexibility. It stated that "[i]f the General Assembly decides that at least some portion of stranded costs should be recoverable, we suggest a legislative approach to the determination of recovery of such costs that is specifically aimed at maintaining reasonable and necessary *flexibility* with respect to policy implementation and administration. We believe that this *flexibility* is critical to serving the

public interest of Virginia in that such a process entails substantial complexity and uncertainty, poses significant public impacts, and must address the unique circumstances of each utility . . . (emphasis added)." . . . "It is essential that rigidity not be incorporated in one component of the transition process that may unintentionally undermine the ultimate objective." *Id.* at 2-3.

A review of the development of the Restructuring Act in general and the stranded cost issue in particular shows that the General Assembly rejected approaches similar to Mr. Spinner's methodology for the same reasons the Commission recommended against them. Both the Commission and the General Assembly refused to embrace long-term, forward-looking projections and asset evaluations as a means of quantifying stranded costs. Instead, the Act incorporates the "lost revenue" approach discussed in Dominion Virginia Power's response to the Commission's Order Establishing Proceeding. Exercises such as those proposed by Mr. Spinner were labeled "a recipe for disaster" that could "unintentionally undermine the ultimate objective." Appendix A, p. 1. While counseling against rigid, up-front calculations, the Commission consistently held that stranded cost recovery mechanisms must be marked by "reasonable and necessary flexibility." *Id.* at 2.

Thus, the Commission has ruled that the "lost revenue" principle that eventually became the foundation of the Restructuring Act's stranded cost recovery provisions is designed to preserve revenue neutrality for incumbents during the transition period. *In the matter of considering requirements related to wires charges pursuant to the Virginia Electric Utility Restructuring Act*, Case No. PUE-2001-00306, Final Order, 2002 Va. PUC LEXIS 397, *9 n.5 (Oct. 11, 2002); *In the matter of considering requirements related to wires charges pursuant to the Virginia Electric Utility Restructuring Act*, Case No. PUE-2001-00306, Final Order, 2001 Va. PUC LEXIS 304, *29 (Nov. 19, 2001) The Commission has also stated ". . . wires charges

[3] The "Attachment" is attached to "Appendix A."

serve as a 'proxy' on a utility by utility basis, of stranded costs. Therefore, no actual determination of stranded costs is necessary . . .." *Application of Northern Virginia Electric Cooperative, for review of tariffs and terms and conditions of service,* PUE-2002-00086, Final Order, 2002 Va. PUC LEXIS 293, *5 n.3 (June 18, 2002).

In short, to the extent Dominion Virginia Power's unbundled generation rates approved by the Commission in PUE-2000-00587 exceed Commission-approved projected market prices, the Act provides for Commission-approved wires charges for customers who purchase electricity from CSPs. During the same period, customers who continue to receive electricity from their incumbent utility pay capped rates. Any such wires charges collected serve to prevent the utility from experiencing lost revenues due to a customer's decision to switch to a CSP. In addition, funds available from capped rates during the transition period may permit a utility to mitigate its above-market costs until July 1, 2007. The amount and timing of such mitigation is the "flexibility" that each utility has under the Act and is consistent with the Commission's recommendation of a "flexible" approach. Attachment, p. 2.

In the final analysis, whether a utility has above-market costs as of July 1, 2007, will depend upon a host of factors. In particular, the answer hinges on the extent of the utility's mitigation during the transition period and on market prices as of July 1, 2007. If the utility is not at market on July 1, 2007, then it has no further right to revenue neutrality, i.e., its generation-related revenues will be determined by the market. If desired by the LTTF, until July 1, 2007, each utility could report annually any amounts collected in wires charges and the extent of its mitigation of above-market costs. Such reporting would allow the LTTF to monitor recovery of stranded costs and the mitigation of above market costs in accordance with § 56-595.

The methodology proposed by Mr. Spinner is not consistent with the Act. Indeed, the notion that a utility's revenue requirement might be determined on an annual basis during the transition period, except at the request of the utility, was never proposed during the years of debate leading up to the Restructuring Act. In fact, the Act compels just the opposite conclusion, as several provisions make clear. For example, except for Dominion Virginia Power, every utility had the option of seeking a "going-in" rate case to have its capped rate levels fixed by the Commission. Significantly, no other party, not even the Commission on its own motion, was permitted under the Act to initiate such a rate case, even if the existing rates were believed to be too high. Second, once capped rates have been established, Code § 56-582 provides only limited means by which those rates may be changed during the transition period: (a) rates may reflect the costs of fuel and purchased power; (b) changes in tax laws can be recognized; (c) financial distress of a utility beyond its control can be remedied; and (d) if a utility's petition to terminate capped rates after January 1, 2004 is rejected, then utilities other than Dominion Virginia Power may request a one-time change in the non-generation components of their rates. Again, except for the fuel and tax provisions, the other means of changing capped rates during the transition period are clearly options held by the utilities, not other parties.[4]

The multi-year rate case type calculation required as the key ingredient of Mr. Spinner's methodology is thus an afterthought with no legal basis. It also lacks any practical underpinnings, as demonstrated by the difficulties and controversies that would be involved in trying to conduct such a proceeding using a "test period" span of seven and a half years and

[4] The provision that permits rate changes to relieve financial distress of a utility quite clearly means that no entity is permitted under the Act to seek changes to rates it believes to be too generous. A key attraction of Mr. Spinner's proposed methodology for some members of the work group appears to be the belief that, if a utility's revenue requirement for the 1999 to 2007 transition period is estimated, it will show that capped rates were, or might be, too high, however that concept might be defined, during that period. However, there simply is no authority under the Act for even raising that question.

attempting to determine, retroactively in large measure, what a utility's revenue requirement would have been but for capped rates and stranded cost mitigation efforts. This proposal comes, in Dominion Virginia Power's case, *after* spending hundreds of millions of dollars on mitigation measures and making hundreds of millions of dollars in new investments.

Mr. Spinner's methodology also ignores the fact that the Commission has refused to accept the complexities and uncertainties of projected test periods in the past. In rejecting even a one-year projection for a Virginia Power application filed on February 15, 1978, the Commission stated that "…in order to use any level of projected expenditures, one must first evaluate the projected date against identifiable and acceptable standards." *Application of Virginia Electric and Power Company, for an increase in rates*, Case No. 19960, Opinion and Final Order, 1979 S.C.C. Ann. Rep. 164, 167 (Mar. 19, 1979). The Commission further stated that "…when presenting projected data, utilities must present the material so as to permit the Staff and other parties to trace projections back to their historical source. All assumptions and changes in activity levels should be quantified and supported to provide a 'link' between the historic test year and the projected data." *Id.* at 168.

Mr. Spinner's methodology may be easy to describe in theory, but, as the Commission has made clear, a 30-year or longer study cannot produce any calculations with reasonable certainty. As we have learned the hard way in recent years, even short-term projections by Wall Street and others have proven to be "pure fantasy." The idea that the working group--or anyone else--can project market prices, capital and operating costs, and make accurate assumptions about generating plant operations for 30 plus years, is an illusion. Mr. Williams put it best: it is a "potential for a public policy disaster . . .." Attachment, p. 3.